IN THE UNITED STATES DISTRICT COURT
FOR THE SOUTHERN DISTRICT OF WEST VIRGINIA
AT CHARLESTON

W.W. MCDONALD LAND CO., *et al*.,

Plaintiffs,

v. **Civil Action No. 2:11-cv-0418**

EQT PRODUCTION COMPANY, *et al*.,

Defendants.

EQT PRODUCTION COMPANY'S MEMORANDUM IN OPPOSITION TO PLAINTIFFS' MOTION FOR PARTIAL SUMMARY JUDGMENT

Defendant EQT Production Company ("EQT Production") submits the following Memorandum in opposition to the Plaintiffs' Motion for Partial Summary Judgment.[1] Plaintiffs' Motion presents two faulty theories: (1) Plaintiffs were underpaid pursuant to *Tawney v. Columbia Natural Resources*, LLC, 219 W.Va. 266, 633 S.E.2d 22 (2006); and, (2) downstream costs were not actually and reasonably incurred. Plaintiffs' arguments fail as set forth below.

STATEMENT OF FACTS

Plaintiffs allege royalty underpayments relating to fourteen oil and gas leases (the "Leases") identified as Leases (a) – (n) in Paragraph 25 of the Amended Complaint (the "Am. Complaint") and attached as Exhibits A-N to Defendants' Joint Motion for Summary Judgment.[2] Twelve of the Leases contain "market value" royalty clauses, several of which include language permitting the deduction of post-production expenses. *See* Plaintiffs' Motion, Exhibits 1-9; 11-

[1] Plaintiffs Motion is directed only to Defendant EQT Production Company. EQT Production has filed a Motion for leave to redact portions of this Memorandum and to file Exh. F, I, L and M, which contain confidential financial information, under seal. It has provided an unredacted copy of its Memorandum to Plaintiffs' counsel and a copy will be hand-delivered to the presiding Judge pending ruling on the Motion.

[2] Plaintiffs' Motion does not include the Lease identified as (j) in the Am. Complaint.

13. One Lease contains a "proceeds" royalty clause. *See* Plaintiffs' Motion, Exhibit 10. A summary of the royalty provisions from each of these Leases is attached as Exh. A.

Plaintiffs are a group of business entities, trusts, and individuals that are collectively and actively involved in natural gas leasing throughout southern West Virginia. They are the lessors of the Leases with EQT, covering approximately 18,000 acres in Logan and Mingo counties. *See* Am. Complaint, ¶ 25. Glenn T. Yost manages the Leases on behalf of Plaintiffs. *See* Exh. B, Yost Transcript, pp. 7-9, 12. Yost has managed oil and gas leasing since 1992, when he became the president of W.W. McDonald Land Company. *Id*.

EQT Production acquired the leases from a group of Statoil entities in 2000 and, as the successor lessee, has the sole right to develop and produce gas on the subject acreage. *See* Answers of all Defendants at p. 5, ¶ 25; p. 6, ¶ 32; and, p. 11, ¶¶ 2-3. *See also*, Exh. C, excerpts of EQT Production's Responses to Plaintiffs' First Set of Interrogatories and Requests for Production of Documents to Defendants, pp. 4-5. Between February 2000 and January 1, 2005, EQT Production, then known as Equitable Production, produced gas from the leased properties, transported it downstream to the interstate connection, and sold it. *See* Exh. D, Bergonzi Transcript, pp. 56-57; Exh. C, pp. 6-7; and, Exh. E, Crites Transcript, pp. 36, 63, 54-63. Royalty was calculated based on volumes of gas sold at the interstate connection. EQT Production paid all costs incurred to gather the gas and transport it to this sales point. EQT Production deducted $0.20 per dekatherm as a gathering rate. *See* Exh. F, Cost of Service Spreadsheet 2000-2004, Gathering and Compression Costs Summary, and excerpts of 10k (collectively attached). This gathering rate was the same rate charged by Statoil. *See* Exh. G, EQT Production Company's Supplementation of Discovery responses and Deposition Testimony, pp. 2-3. The chart below

shows the gathering rates charged and the actual costs EQT Production incurred from 2000 to 2005.

Year	Gathering Rate ($/dth)	Actually incurred (averaged as $/dth)
2000		
2001		
2002		
2003		
2004		

See Exh. F. No deductions were taken by EQT Production for depreciation or return. *See* Exh. D, p. 91.

A. ROYALTY PAYMENTS AFTER JANUARY 1, 2005

Since 2005, EQT Production has not taken deductions. EQT Production sells gas at the well. *See* Exh. C, p. 7; and *see* Exh. E, pp. 66, 69. On January 1, 2005, EQT Production reorganized to separate out its "midstream" business. *See* Exh. H, Affidavit of John Bergonzi; Exh. D, Bergonzi Transcript, pp. 65. As part of the reorganization, EQT Production entered into a gas purchase contract with EQT Energy providing for a wellhead sale at a price equal to the first of the month index price applicable to the interstate pipeline(s) into which the gas is delivered, less gathering-related charges, retainage, and any other agreed to charges. *See* Exh. C, p. 7; Exh. E, p. 66, 69; and Exh. I, 2005 Base Contract for Sale and Purchase of Natural Gas, "Attachment 1." Per the agreement, EQT Production receives payment for volumes that make it to the interstate connection, and royalty is paid on the amount EQT Production receives. *See* Exh. C, p. 7; and, *see* Exh. J, Lowe Report, ¶ 9. The "work-back methodology" pricing per the agreement is aimed at ensuring receipt of market value at the well. *See* Exh. C, pp. 4-7; Exh. K, Lowe Transcript, pp. 25-29.

At the time the gas purchase agreement was executed, EQT Energy also entered into gathering contracts with the newly-created gathering companies. The gathering agreements

provide for the transportation of gas from the EQT Production sales point to the interstate connection in exchange for EQT Energy's payment of gathering charges based on a cost-of-service rate, which is calculated based on historical actual costs by operating district. *See* Exh. L, Gas Gathering Agreement. While the gathering rate charged to EQT Energy (and utilized as part of the pricing formula in the agreement with EQT Production) includes depreciation and return components, EQT Production adds the depreciation and return into the price received from EQT Energy before calculating the Plaintiffs' royalties. *See* Exh. D, p. 91. As such, since 2005 EQT Production pays royalties on a price higher than 1/8th of the sales price it receives.

The following chart summarizes gathering rates utilized from 2005 through 2012. *See* Exh. M, Cost of Service Spreadsheet 2005-2011, Cost of Service Spreadsheet 2012-2013, and Gathering and Compression Costs Summary (redacted). The EPC Rate is the rate used for the gathering charge component in the pricing formula per the gas purchase agreements. The rate used to calculate royalties (after adding in the value of depreciation and return into the sales price) is less and is less than the actual gathering charges. This is the RI rate.

Year	Rate used to calculate sales price (EPC Rate)	Rate used to Calculate Royalty (RI)	Actual Costs ($/dth)
2005			
2006			
2007			
2008			
2009			
2010			
2011			
2012			

ARGUMENT

A. PLAINTIFFS' "CASE HISTORY" IS FLAWED

Plaintiffs' history of royalty law does not paint a full picture.

1. The early cases Plaintiffs cited involved limited facts and holdings that do not support the expansive construction given to them by Plaintiffs

The early cases cited in the "Memorandum of Law in Support of Plaintiffs' Motion for Partial Summary Judgment" (Plaintiffs' "Memorandum") include facts and legal issues that differ from those in this case.

The facts in *Kohlsaat v. Main Island Creek Coal Co.*, 90 W.Va. 656, 112 S.E. 213 (1922) have important differences from those in this case. There, the court held that the lessee could not deduct commissions paid by the lessee to a sales agent employed to assist with the sale of coal. Importantly, the lease in that case provided for a royalty of 10% of the sale price. There was no language similar to that being considered by this Court in the current matter that contemplates valuation of the mineral at a certain point (for instance, "at the tipple" or "after deducting costs incurred to get the coal to the point of sale"). Instead, the language at issue in *Kohlsaat* was clear and unambiguous, requiring that the calculation be made on the gross sale price, i.e., the price received for the sale of coal, regardless of where that sale took place. *Kohlsaat*, 90 W.Va. 656, 112 S.E. at 218. Express language in the leases specifying the location at which gas is to be valued – which was absent in the *Kohlsaat* case – cannot be ignored. Since 2005, EQT Production's payment practices comport with the factual scenario addressed in this case: EQT Production has been paying Plaintiffs a royalty based upon the price it receives. *See* Exh. K, pp. 25-29. Moreover, contrary to the charge made by Plaintiffs, EQT Production has never deducted production costs, including its employee overhead, from Plaintiffs' royalty.

2. *Cotiga* supports EQT's payment practices

While Plaintiffs insist *Cotiga Dev. Co. v. United Fuel Gas Company,* 146 W. Va. 484, 128 S.E.2d 626 (1964), supports their argument that royalties should always be paid on 1/8th of the market value at the interstate connection, that is simply not what the case says. In *Cotiga*, the

West Virginia Supreme Court examined a royalty provision providing that a 1/8th royalty would be paid on "the rate received by the lessee for such gas." *Id.* at 488, 628. The Court held the royalty language was clear and unambiguous that the wellhead price was not sufficient where gas was being sold after commingling and transportation. *Id.* at 492, 633. There was no "wellhead" language in the *Cotiga* lease, and the Court noted,

> if the parties had desired to do so, they could so easily have said that royalties were to be computed on the basis of the wellhead price. It is obvious from this case that such is not an unusual provision in gas leases. No such restriction appears in the rather embracive language used, and we cannot interpolate such a restriction in the plain language employed by the parties themselves.

Id. at 493, 633. This opinion makes three important points: (1) a wellhead price is something different than a downstream price, and (2) it is not uncommon, despite Plaintiffs' arguments, for royalties to be limited to wellhead value, and (3) where royalty is paid based on the priced received and the lease provides that this is how payments should be made, courts should not interpret lease language to call for a price *higher* than that received by the producer. Significantly, Leases g, h, k, l, m, and n at issue here (Exhibits 8-13 attached to Plaintiffs' Motion) contain the "sales price received" type language addressed in *Cotiga.* With regard to those leases, the Court cannot interpret those leases, but must apply it for the 2005 to present time period because EQT Production pays royalties based on the price it receives. Further, with regard all post-2005 royalties, *Cotiga* supports EQT's position that its wellhead sale should be upheld. Finally, with regard to pre-2005 royalties, *Cotiga* lends credence to the argument that where wellhead language is utilized, downstream pricing is not what was contemplated, and this was widely accepted by the industry since at least 1962.

3. Market value leases must be examined differently than proceeds leases

All but two of the Leases direct that royalty shall be calculated based upon the market value of the gas at the wellhead. *See* Lease N, Exhibit 10 attached to Plaintiffs' Motion.[3] Some of the Leases contain additional express language elaborating on how the price at the wellhead is determined. In their Memorandum, Plaintiffs argue that there is no significant distinction between leases providing that royalty shall be calculated according to "market value" and "proceeds." To the contrary, West Virginia law recognizes that these types of royalty clauses have important differences. "Under a market value clause, royalties are paid based upon the market value of the gas; under a proceeds royalty clause, upon the amount of money received by the lessee upon its sales of gas." *Imperial Colliery Company v. OXY USA, Inc*., 912 F.2d 696, 700 (4th Cir. 1990). The distinction between these types of leases is important here, where beginning on January 1, 2005, gas was sold by EQT Production at the well, and the *market value of the gas at the well* upon which royalty is to be calculated for twelve of the fourteen Leases must be determined. The price EQT Production receives is calculated using a "work-back methodology," which is an objective formula utilized to ensure that proceeds are reflective of fair market value at the wellhead.

Market value is the price a willing seller obtains from a willing buyer. *Exxon Corp. v. Middleton,* 613 S.W. 2d 240, 246 (Tex. 1981). There are generally two methods that are accepted in the oil and gas industry and courts throughout the country for determining market value at the well: (1) comparable sales, and (2) the work-back method. *Heritage Resources, Inc. v. Nations Bank,* 939 S.W.2d 118 (Tex. 1996). The work-back method involves subtracting post-production costs that enhance the value of the gas from the interstate connection price to arrive at

[3]As previously noted, Plaintiffs' Motion does not address Lease J.

the value of the gas in its unprocessed state at the well. *See, e.g., Id., Potts v. Chesapeake Exploration, LLC,* 2013 WL 874711 (N.D. Tex 2013); *Clear Creek Oil & Gas Co. v. Bushmiaer,* 264 S.W. 830, 832 (Ark. 1924); *Howell v. Texaco*, 112 P.3d 1154, 1159 (Okla. 2004); *Sternberger v. Marathon Oil Co.,* 894 P.2d 788 (Kan. 1995). Work-back methodology is commonly used where, as here, it is difficult to determine comparable sales. Rather than assuming a negotiated wellhead rate would be upheld between affiliates, EQT Production and EQT Energy agreed to utilize a recognized objective standard to determine a fair wellhead price.

Imperial Colliery recognizes that market value at the well and proceeds value royalty clauses are different, and require different considerations in determining the value of the gas upon which royalty shall be calculated. It also indicates that West Virginia may, as other states have, recognize that the work-back methodology is an appropriate means of calculating market value at the well. The *Imperial Colliery* Court considered whether paying proceeds to a royalty owner under a market value lease was sufficient. In that case, the Court made clear that regardless of the price received – whether higher or lower – the lessor in a market value lease is entitled to his proportionate share of the market value of the gas at the agreed upon valuation location. *Imperial Colliery Co.,* 912 F.2d at 700. In fact, *Imperial Colliery*, which was represented by J. Thomas Lane (lead counsel in the current matter for Plaintiffs), argued that the work-back methodology could have been used to determine market value at the wellhead where gas was sold to Equitable downstream. The Court noted this in its opinion:

> [T]hat there was no available wellhead price does not necessarily preclude computation of the gas' wellhead price. For example, Imperial's witness Malcolm testified that such a computation might simply be made by taking [the] purchase price and deducting compression and gathering expenses.

Id. at 701. Counsel for Plaintiffs now wishes to disregard the distinction he made with success in the *Imperial Colliery* case. This case acknowledges that (1) where market value at the well

royalty language exists, the price upon which royalties should be based should reflect the value of the gas *at the well* – not downstream; and (2) utilization of the work-back methodology by EQT in calculating both pre-2005 (in deducting post-production expenses to arrive at the wellhead value) and post-2005 royalties (in incorporating that methodology into its wellhead pricing formula) at the very least raises a genuine issue of material fact for trial.

The West Virginia Supreme Court has never determined how market value *in a wellhead sale* actually occurs. Unlike *Tawney* and *Wellman v. Energy Resources, Inc.,* 210 W.Va. 200, 211, 557 S.E.2d 254, 265 (2001), the issue before this Court with respect to post-2005 royalty payments is not whether a lessee may take deductions, but whether the royalty received is truly reflective of the market value and/or proceeds at the wellhead in light of the fact that the sale of gas occurs at the wellhead. The work-back methodology utilized since 2005 does just that.[4]

B. *TAWNEY* ANNOUNCED NEW RULES REGARDING LEASE DRAFTING AND INTERPRETATION AND SHOULD NOT BE RETROACTIVELY APPLIED

Tawney was decided on June 15, 2006. Plaintiffs are correct in describing *Tawney* as a "landmark decision." *See* Plaintiffs' Memorandum, p. 12. It is a landmark decision that should not be retroactively applied.

Tawney announced new law requiring an unprecedented level of heightened specificity in lease drafting. *Tawney v. Columbia Natural Resources*, LLC, 219 W.Va. 266, 633 S.E.2d 22 (2006). In answering a certified question, the court held that "at the well," "at the wellhead," "net all costs beyond the wellhead," "less all taxes, assessments, and adjustments," or similar royalty language, without any additional language, is ambiguous *when gas was not sold at the well* and is not sufficient to permit the lessee to deduct from royalty costs incurred between the wellhead and the point of sale. Syl. pt. 10 and 11, *Tawney*, 219 W.Va. 266, 633 S.E.2d 22.

[4] Interestingly, J. Richard Emens, Esquire, Plaintiffs' rebuttal expert, did not know whether any state utilized the work-back methodology. *See* Exh. N, Emens Transcript, pp. 28-29.

Tawney did not, as Plaintiffs suggest, prohibit allocation of downstream costs in all circumstances. The court held that, if a gas lease intends to allocate to the lessor a portion of the costs incurred in moving gas from the wellhead to the interstate connection where it is sold, the lease must: (1) expressly provide that the lessor shall bear some part of the costs incurred between the wellhead and sales point; (2) identify with particularity the specific deductions the lessee will take from the lessor's royalty; and (3) indicate the method of calculating the amount to be deducted from the royalty for such post-production costs. *Id*. at Syl. pt. 10.

The court's holding did not overrule prior judicial precedent but announced new points of law as published in Syllabus Points 10 and 11 of that opinion. In such a circumstance, West Virginia law directs that the following factors should be considered in determining whether to extend full retroactivity to these new principles: (1) whether the new principle of law was an issue of first impression whose resolution was clearly foreshadowed; (2) whether the purpose and effect of the new rule will be enhanced or retarded by applying the rule retroactively; and (3) whether full retroactivity of the new rule would produce substantial inequitable results. *See Caperton v. A.T. Massey Coal Co., Inc*., 225 W.Va. 128, 158, 690 S.E.2d 322, 352 (2009). Consideration of these factors confirms that *Tawney* is not appropriately retroactively applied.

The new law announced in *Tawney*, which answered a certified question, was not clearly foreshadowed by prior decisions. Syllabus Points 10 and 11 mark fundamental changes to West Virginia's contract interpretation rules. They announced new directives as to how gas leases are to be drafted and interpreted, mandating specific and detailed language to allocate costs. It went beyond application of the rule of strict construction and instead adopted rigid drafting rules.

Prior to *Tawney*, lessees paid royalties to lessors under the reasonable belief that, stating the royalties are due "at the wellhead" or even more specific wellhead value versus downstream

language, expressed clear intent that lessors would share in downstream costs. *See e.g. Wellman v. Energy Resources, Inc.,* 210 W.Va. 200, 211, 557 S.E.2d 254, 265 (2001) (recognizing the language of the leases in that case providing "that the 'proceeds' shall be from the 'sale of gas as such at the mouth of the well where gas ... is found' might be language indicating that the parties intended that the … lessors[] would bear part of the costs of transporting the gas from the wellhead to the point of sale."). *See also*, *Cotiga Development Co.,* 147 W.Va. 484, 128 S.E.2d 626 (finding that a wellhead price could be provided for by simply stating it in the lease). *Tawney* placed new burdens with respect to the allocation of post-production costs on lessees whose leases included the type of language found ambiguous. Given this, the purpose and effect of *Tawney's* new rules are not enhanced by applying them retroactively. To the contrary, full retroactive application will "produce substantial inequitable results." *Caperton*, 225 W.Va. at 158, 690 S.E.2d at 352.

Several of the Leases were executed in 1949 and the early 1950s. *See* Am. Complaint, ¶25. When these Leases were executed, no party could have anticipated that 50 years in the future the *Tawney* particularity requirements would be announced. Nor could anyone have reasonably contemplated that it would be necessary – to clarify their intent – that the "method" of calculating deductions must be explained in the lease. These requirements go further than historical contract construction rules utilized for any kind of agreement. Indeed, when these Leases were executed, the law clearly recognized that the wellhead value/price is different than downstream value. *See, e.g, Cotiga Development Co.*, 147 W.Va. 484, 491-93, 128 S.E.2d 626; 632-34. Application of *Tawney's* "particularity" requirement to these Leases would create a result directly contrary to the Lease language agreed upon, which was drafted before the heightened language requirements announced in that case. *See, e.g., McGinnis v. Cayton,* 173 W.

Va. 102, 312 S.E.2d 765 (1984); *Huntington Water Corp. v. City of Huntington*, 115 W. Va. 531, 177 S.E.290 (1935) (recognizing that, in interpreting a contract, it is appropriate to look at the law in existence at the time the contract was entered into). *See also* Exh. O, Yost Transcript, pp. 28-31. Even if this Court believes *Tawney* should be applied to leases entered into before the date of that decision, its retroactive application to the royalties paid prior to the date of the decision is still improper under the *Caperton* analysis for the same reasons set forth above. As such, Plaintiffs are not entitled to summary judgment.

C. SUMMARY JUDGMENT FOR PLAINTIFFS IS NOT PROPER EVEN IF *TAWNEY* IS APPLICABLE

In their rush to apply *Tawney*, Plaintiffs overlook important facts that preclude summary judgment. The issues to be decided in considering Plaintiffs' Motion are not, as framed by Plaintiffs, simply whether *Tawney* is applicable. Contrary to Plaintiffs' allegation, the basis upon which royalties were/are calculated differs significantly before and after 2005 because of the shift in the sales point and the change in EQT Production's payment practices. Plaintiffs acknowledge this change, but dismiss it summarily. *See* Plaintiffs' Memorandum, p. 18. Plaintiffs also argue that EQT Production's admitted allocation of Plaintiffs' proportionate share of downstream costs prior to 2005 entitles them to summary judgment. This claim is, however, untenable as a number of the Leases expressly permit the deduction of a share of post-production costs from Plaintiffs' royalty payment which precludes summary judgment.

1. *Tawney* is inapplicable to royalties paid after January 1, 2005

Plaintiffs offer no valid counter to the fact that EQT has taken no deductions since 2005. They suggest that this sale should be disregarded, but offer no real reason why other than that the sale is to an affiliate. The price is fair: the work-back methodology used to determine the wellhead sales price is a generally accepted in the industry and by courts. *See e.g. Exxon Corp.,*

613 S.W. 2d 240; *Heritage Resources, Inc.,* 939 S.W.2d 118; *Clear Creek Oil & Gas Co.,* 264 S.W. 830; *Howell*, 112 P.3d 1154; *Sternberger,* 894 P.2d 788. As noted above, it was argued as an acceptable means of calculating market value at the well by Plaintiffs' counsel in a prior case. In fact, Plaintiffs' expert, Randy Kaplan, offers no opinion that the sales/purchase price for gas was/is below market value. *See* Exh. P, Kaplan Transcript, pp. 54-59. When presented with the example of a similar contractual arrangement involving a non-affiliated entity, Kaplan agreed such an arrangement would be appropriate. *Id.* Plaintiffs receive a full 1/8th of the market value AND proceeds at the well. Not only do EQT Production's practices meet the lease provisions for payments on proceeds leases, but also market value leases because the sales formula achieves a market value sale. Indeed, the reasoning of *Tawney* supports EQT Production's practices because EQT Production's lessors receive "a royalty based on the sale price of the gas received by the lessee." *Id*. at 219 W.Va. at 271-272, 633 S.E.2d at 27-28.

Moreover, the *Tawney* court made it clear that the only ambiguity in the market value leases was the fact that *the lessee was not selling gas there*. *Tawney,* 219 W. Va. at 273, 633 S.E.2d at 29. Where, as here, the sale takes place at the wellhead, no ambiguity exists, and Plaintiffs simply are not entitled to summary judgment for this time period.

2. Leases (k), (l), and (m) express a clear intent to allocate post-production costs

Tawney directs that for a lease to allocate between the lessor and lessee a portion of the costs of marketing and transporting the product to the point of sale, the lease must: (1) expressly provide that the lessor shall bear some part of the costs incurred between the wellhead and the point of sale; (2) identify with particularity the specific deductions the lessee intends to take from the lessor's royalty; and, (3) indicate the method of calculating the amount to be deducted from the royalty for such post-production costs. Syl. pt. 10, *Tawney*, 219 W.Va. 266, 633 S.E.2d 22.

Here, three of the Leases include terms expressing a clear intent to allocate the costs downstream costs between the Lessors (Plaintiffs) and the Lessee (EQT Production) which undoubtedly meet the requirements announced in *Tawney*. These Leases provide, *inter alia*, that, if gas is sold at a point other than the well, in calculating Plaintiffs' royalty, EQT Production may deduct a reasonable charge for compressing, desulphurization and/or transportation of the gas from the well to the point of sale. *See* Exh. A, Summary of Leases K, L and M.

Plaintiffs' contention that these Leases do not meet *Tawney's* drafting requirements is without merit. Each expressly states the circumstances in which the Lessors/Plaintiffs shall bear part of the costs incurred between the wellhead and the point of sale, identifies the specific deductions to be taken from the Lessors' royalty (compressing, desulphurization, transporting), and indicates the method of calculating deductions ("adjusting downward" from the price received). In fact, Yost, who has managed oil and gas leases since 1992, admitted in his deposition that this lease language appears to contemplate deductions. He believes, however, that *Tawney* entitles Plaintiffs to a better bargain than the parties made. *See* Exh. O, Yost Tr., pp. 28-31, 36-38 (admitting that it appears that Lease language contemplated deductions). Having expressed the clear intent of the parties, however, these Leases terms should not be construed or interpreted, but simply applied and enforced. *See Tawney*, 219 W.Va. at 272, 633 S.E.2d at 28; Syl. pt. 1, *Cotiga Development Co.,* 147 W.Va. 484, 128 S.E.2d 626 ("[a] valid written instrument which expresses the intent of the parties in plain and unambiguous language is not subject to judicial construction or interpretation but will be applied and enforced according to such intent"); *Chapman-Martin Excavating & Grading, Inc. v. Hinkle Contracting Co., LLC*, No. 2:11–cv–00563, 2011 WL 5999868, at *3 (S.D.W.Va. Nov. 30, 2011).

The Leases identified as (k), (l) and (m) in Plaintiffs' Am. Complaint clearly permitted the deductions made by EQT Production for post-production costs for the period prior to 2005. Plaintiffs' request for summary judgment with respect to these Leases must, therefore, be denied.

3. Leases (g), (h), and (n) contemplate sales at a location other than the wellhead

In addition to Leases (k), (l), and (m), which expressly permit deductions for post-production costs, three (3) other Leases at issue - identified in Plaintiffs' Am. Complaint as Leases (g), (h), and (n) - further identify and contemplate the sale of gas at a place other than the wellhead. Lease (n) also directs that there should be a cap on royalties to be recovered by Lessor under this Lease. *See* Exh. A, Summary of Leases G, H, and N.

Leases (g) and (h) clearly anticipate wellhead pricing even if there is no wellhead sale. This is evident because the language acknowledges that the sale may take place at some other point but still provides that the wellhead price is appropriate. Further, Lease (n) assumes that deductions may also be taken as it caps the royalty at 1/8th of what the Lessee *actually receives* for the gas.[5] Having expressed the intent of the parties in plain and unambiguous terms, these Leases are not subject to judicial construction or interpretation and their terms must be applied and enforced. *See Tawney*, 219 W.Va. at 272, 633 S.E.2d at 28; Syl. pt. 1, *Cotiga Development Co.,* 147 W.Va. 484, 128 S.E.2d 626. Certainly, *Tawney* should not be interpreted under these circumstances to require application directly contrary to the clear intent of the parties.

4. Plaintiffs are not entitled to payment on lost and unaccounted for gas ("LUFG")

Plaintiffs argue that *Tawney's* directive regarding deductions for post-production expenses includes "deductions" for lost volumes. The volume of gas measured at each wellhead is reported to the Division of Environmental Protection. During transport from the well to the

[5] Note that this language is substantially similar to the language that the court found to be unambiguous in *Cotiga.*

interstate connection, some gas is lost or unaccounted for due, for example, to leaks encountered during pipeline operation, dissipation, metering inaccuracies, or use as fuel. *See e.g. Colorado Interstate Gas Company v. Federal Energy Regulatory Commission*, 599 F.3d 698, 700 (D.C.Cir. 2010) ("The amount of gas a shipper delivers to a pipeline will never be exactly the same as the amount of gas that arrives at the destination. In the course of moving gas from one place to another, some of it is lost due to small leaks or metering errors.)

Notably, each of the subject Leases contains language regarding lost volumes:

- Lease (a), (k) and (l) state that royalties should be paid on volumes "produced and marketed." *See* Plaintiffs' Motion, Exhibits 1, 11, 12.
- Leases (b), (c), (d), (e) and (n) say royalties should be paid on volumes "produced and sold." *See* Plaintiffs' Motion, Exhibits 2-5, 10.
- Lease (f) states for certain acreage royalties are due on volumes "produced and marketed" and for other acreage royalties are due on volumes "produced and sold or marketed." *See* Plaintiffs' Motion, Exhibit 7.
- Leases (g), (h), and (m) provide that royalties should be paid on volumes "produced, saved and marketed." *See* Plaintiffs' Motion, Exhibits 8, 9, 13.
- Lease (i) states that royalties are due on volumes "produced and saved." *See* Plaintiffs' Motion, Exhibit 6.

According to the express language of these Leases, royalty is to be paid only on volumes that are marketed or sold. This is what EQT Production has done. Both before and after 2005, EQT Production neither marketed nor sold lost volumes because no payment for those volumes was ever received. Thus, Plaintiffs' are not entitled to payment on these volumes.

Contrary to Plaintiffs' contention, *Tawney* does not support their claim that they are entitled to payment on lost volumes. Neither of the new points of law announced in *Tawney* addresses the issue of whether a lessee must pay royalty to a lessor for LUFG for which the lessee is not paid. LUFG is not sold by producers such as EQT Production and does not involve a monetary deduction from the sales price of the gas. These losses are *not* costs charged to

Plaintiffs. While the *Tawney* opinion notes that the defendant in that case took what the court identified as "volume deductions" from the royalties paid to the plaintiff owners, the court's holding addresses only post-production monetary expenses or costs actually charged against and deducted from the plaintiffs' royalty. *Id.* at 269, 271-272, 633 S.E.2d at 25, 27-28. Although "volumetric deductions" are mentioned by the West Virginia Supreme Court of Appeals in the fact section of *Tawney*, the lower court in that case was not asked to consider the issue of line loss in the motion for summary judgment considered by the court.[6] Significantly, *Tawney* issued no Syllabus Points on what constitutes a post-production cost. The certified questions posed to the Supreme Court related only to monetary deductions from royalty payments where "at the wellhead" and similar language is used in an oil and gas lease. *See* Exh. Q, excerpts of the Brief of Defendant Columbia Natural Resources, LLC, on Certified Questions, pp. 22-23. Plaintiffs' demand for royalties on gas used to fuel compressor stations must fail for the same reasons.

Additionally with regard to fuel, compressor stations on two of the Leases expressly permit the free use of gas. These Leases provide in pertinent part:

- "LESSEE shall have the privilege of using sufficient … gas from the leased premises free of royalty or any other charge to run all machinery necessary for drilling and operating thereon …" (*See* Plaintiffs' Motion, Exhibit 12, p. 7); and,

- "Lessee shall have the right to use, free of cost, gas … found on said land for its operations …" (*See* Plaintiffs' Motion, Exhibit 10, p. 2).

According to the clear provisions of these Leases, EQT Production is expressly authorized to use gas from the property – free of any royalty or charge – as is necessary for its operations in producing gas from the tracts. Having expressed the parties' intent in plain and unambiguous terms, these Leases are not subject to judicial construction or interpretation and their terms must be applied and enforced. *See* Syl. pt. 1, *Cotiga Development Co.,* 147 W.Va.

[6] Questions were certified after the trial court denied CNR's motion for summary judgment, and the certified questions addressed only the issues CNR raised in their motion.

484, 128 S.E.2d 626 (1962); *Chapman-Martin Excavating & Grading, Inc. v. Hinkle Contracting Co., LLC*, No. 2:11–cv–00563, 2011 WL 5999868, at *3 (S.D.W.Va. Nov. 30, 2011).

Because EQT Production never "markets" or "sells" lost or consumed gas, and because fuel is expressly permitted in the Leases, Plaintiffs' claim regarding volumetric losses must fail.

D. PLAINTIFFS MISREPRESENT THE GATHERING RATES, WHICH HAVE BEEN REASONABLE AND LESS THAN ACTUAL

Plaintiffs misrepresent both the amount of deductions taken from 2000-2004 and how EQT Production calculates the royalty for the years 2005 to present. In addition to incorrectly suggesting that EQT Production simply deducts a percentage (10%), Plaintiffs disingenuously argue that EQT Production charges Plaintiffs at a rate that is simply not applied. Plaintiffs have been informed of this fact at numerous points throughout discovery. *See* Exh. C, pp. 4-5; Exh. D, pp. 58, 65-66; Exh. E, pp. 56-66, 81-95, 99-111; Exh. G; Exh. K, pp, 25-29.

From 2000 to 2004, EQT Production deducted a gathering rate of $[REDACTED] from Plaintiffs' royalties. *See* Exh. F. As reflected in the summary set forth above, this amount is less than the actual gathering costs incurred by EQT Production. *Id.*

From 2005 to present, EQT Production has not directly incurred any gathering charges because the gas belongs to EQT Energy while in the gathering system. Those costs were made a component of the pricing formula for the wellhead sale of the gas to EQT Energy, which is the party directly incurring such downstream costs. However, the rate used to calculate the royalty (after adding in the value of depreciation and return on investment into the sales price) is much less and is *less than the actual gathering and compression charges*. Plaintiffs reference the year 2011 in an attempt to make its point, but misrepresent the actual data. *See* Plaintiffs' Memorandum, p. 2-3. They represent that EQT Production charged Plaintiffs $[REDACTED] and stated that the audited costs were $[REDACTED]. *Id.* This is not the case. Of the [REDACTED] gathering

rate applied to the index price for purposes of calculating EQT Production's price, only [REDACTED] was applied to the index pricing to calculate Plaintiffs' royalty. *Id.* *See also*, Exh. M. In short, EQT Production gave Plaintiffs a better deal than EQT Production received. Not only were Plaintiffs not made subject to the full gathering rate utilized to calculate EQT's sale price, but also, their royalties did not include a reduction for the full actual costs associated with gathering ($[REDACTED]) as the gas purchase agreement requires. Plaintiffs receive a royalty which is more than 1/8th EQT Production receives for the sale of the gas and more than 1/8th of the wellhead market value based on actual gathering costs. These facts were explained to Plaintiffs at numerous points throughout discovery. *See* Exh. C, pp. 4-5; Exh. D, pp. 58, 65-66; Exh. E, pp. 56-66, 81-95, 99-111; Exh. G; Exh. K, pp, 25-29.

Because EQT Production has charged less than actual gathering charges incurred by it prior to 2005 and has adjusted the sales price to reflect an amount less than the actual gathering charges since that time, it has met its burden required by *Wellman, supra*, that the charges actually be incurred.

The fact that the charges are less than actual gathering costs also precludes summary judgment on the allegation that they were not reasonable. Less than actual could certainly be determined by a fact finder to be reasonable.

Moreover, the factors that go into determining the gathering rate are similar to what is utilized by any prudent company (i.e., planned operating costs including field personnel, pipeline repairs and maintenance, compressor repairs and maintenance, measurement, property taxes, depreciation and return and general and administrative costs). *See* Exh. R, "Plaintiffs First Set of Interrogatories and Requests for Production of Documents to EQT Gathering, Inc., EQT Gathering Equity, LLC, and EQT Gathering, LLC," pp. 8-9. The rates are based upon a district-

wide calculation with proportionate costs allocated back based upon volumes gathered. *See* Smith Transcript, pp. 31-32. There has been no evidence presented in discovery that the rates are not reasonable. Given these factors, the "reasonable" factor required by *Wellman* has been met.

CONCLUSION

WHEREFORE, for the reasons stated in this Memorandum, in the Memorandum to Support Defendants' Joint Motion for Summary Judgment which is incorporated as if fully stated herein, and to be asserted upon oral argument, Defendant EQT Production Company respectfully requests that Plaintiffs' Motion for Partial Summary Judgment be denied.

EQT PRODUCTION COMPANY,

By Counsel.

/s/ David K. Hendrickson 10/21/2013

David K. Hendrickson, Esquire (#1678)
HENDRICKSON & LONG, P.L.L.C.
214 Capitol Street (zip 25301)
P.O. Box 11070
Charleston, West Virginia 25339
(304) 346-5500
(304) 346-5515 (facsimile)
daveh@handl.com

IN THE UNITED STATES DISTRICT COURT
FOR THE SOUTHERN DISTRICT OF WEST VIRGINIA
AT CHARLESTON

W.W. MCDONALD LAND CO., *et al*.,

Plaintiffs,

v. **Civil Action No. 2:11-cv-0418**

EQT PRODUCTION COMPANY, *et al*.,

Defendants.

CERTIFICATE OF SERVICE

I, David K. Hendrickson, counsel for Defendants, do hereby certify that I have this **21st day of October, 2013**, served the foregoing **"EQT PRODUCTION COMPANY'S MEMORANDUM IN OPPOSITION TO PLAINTIFFS' MOTION FOR PARTIAL SUMMARY JUDGMENT"** electronically through the Court's CM/ECF system which will notify and deliver a copy of the same to the following counsel of record:

J. Thomas Lane, Esquire
J. Mark Adkins, Esquire
Bowles Rice LLP
600 Quarrier Street
P.O. Box 1386
Charleston, West Virginia 25325-1386

/s/ David K. Hendrickson 10/21/2013

David K. Hendrickson, Esquire (#1678)
HENDRICKSON & LONG, P.L.L.C.
214 Capitol Street (zip 25301)
P.O. Box 11070
Charleston, West Virginia 25339
(304) 346-5500
(304) 346-5515 (facsimile)
daveh@handl.com